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Hedge Funds As An Asset Class

TRADITIONAL INVESTMENTS

- Private Banking/Trust Company
- Mutual Funds
- Professional Money Management
- Individual Brokerage Accounts
- Unit Investment Trusts

CORRELATED TO STOCK AND BOND MARKETS

ALTERNATIVE INVESTMENTS

- Venture Capital
- Private Equity
- Hedge Funds
- Real Estate
- Leveraged Buyouts (LBOs)

<u>NOT</u> CORRELATED TO STOCK AND BOND MARKETS

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Traditional Managers vs. Hedge Funds

	TRADITIONAL MANAGER	HEDGE FUND MANAGER
1. Performance Objective:	– Manage to Benchmark – Correlated to Market Movement	– Opportunistic (No Benchmark) – Low Correlation to Market Movement
2. Success Determinants:	– Stock Selection – Market Direction	– Stock Selection – Downside Risk Management – Profit from Shorts (Hedging Skills)
3. Fees:	– Asset Based	– Performance Based
4. Manager Participation:	– Manager Prohibited from Owning Stocks in Portfolio	– Manager Always Invests Alongside Limited Partners
5. Portfolio Exposure:	– Tends to be 90-100% Invested at All Times (Even in Bear Markets)	– Can Reduce "Net Long" Exposure by Increasing Shorts and/or Cash – Can Be "Net Short" the Market

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Hedge Fund Portfolio Management

Controllable Portfolio Risk

- Stock Selection
  - –Fundamental Analysis
  - –Information Flow
  - –Technical Analysis
- Entry/Exit Decisions
  - –When to Buy/Sell a Stock
- Net Exposure to Market
  - –Longs minus Shorts
  - –Cash

Non-Controllable Portfolio Risk

- Political Risk (War, OPEC)
- Monetary Risk (Fed Tightening)
- Fiscal Risk (Budget Deficit)
- Currency Risk (Trade Deficit)
- Market Imbalances (Unexpected Bankruptcy…Enron)
- Market Panic (September 11, 2001)

HEDGE FUND MANAGERS ATTEMPT TO "HEDGE OUT" NON-CONTROLLABLE RISK TO REALIZE THE FULL BENEFIT OF THEIR STOCK SELECTION

TRADITIONAL MONEY MANAGERS CAN NOT EFFECTIVELY DO THIS

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Farmer…….Risk Management Concept (revisited)

Controllable Risk

- What crop to plant
- When to plant and harvest
- To "hedge" or "not to hedge"

Non-Controllable Risk

- Nature Risk (Weather, Earthquake)
- Political Risk (War, Trade)
- Monetary Risk (Fed Tightening, Financing Cost)
- Fiscal Risk (Budget Deficit, Govt. Subsidies)
- Market Imbalances (Supply/Demand for Crop)
- Market Panic (September 11, 2001)

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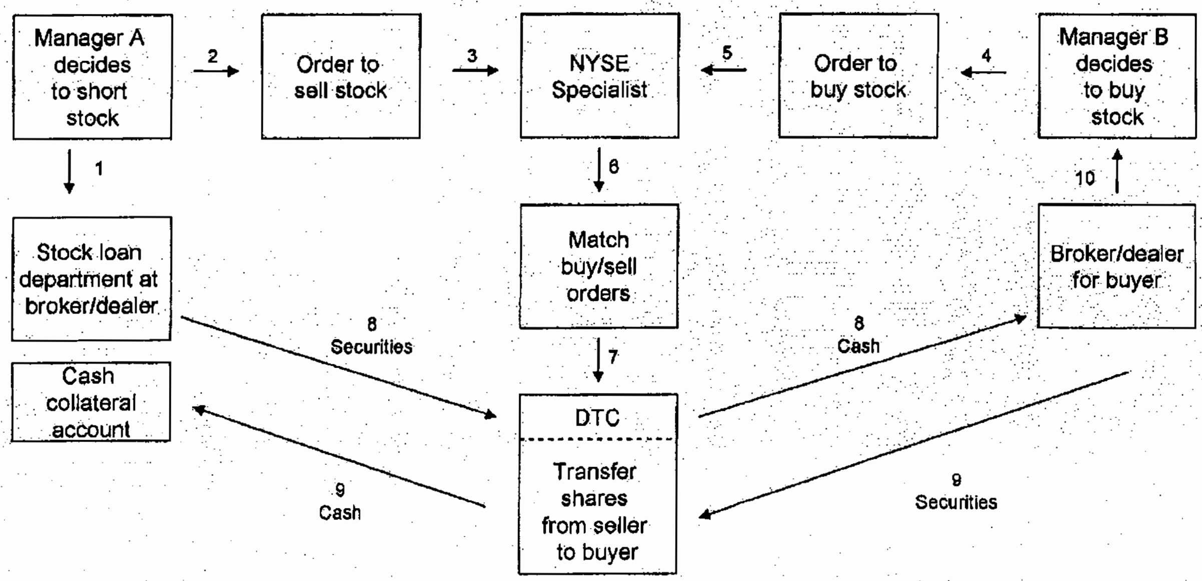
The Short Sale…Essential To Hedging



Sell short 1 IBM share on 2/4/04	**\$91 per share**
Buy 1 IBM share (cover short) on 8/12/04	**\$82 per share**
Profit	**\$9 (Return on Investment of 10%)**

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Hedging Out Non-Controllable Risk

Market Related…Most Common Ways to Hedge Declines in the Equity Market

- Buy S&P 500 Puts
- Sell S&P 500 Calls
- Sell S&P 500 Futures

Portfolio Related…Stock Specific Hedging

- Short stocks that have a higher beta than stocks on the long side
  - Lose money on the longs but offset loss with profits on the shorts
- Buy puts against a long stock position
- Sell calls against a long stock position…lowers cost basis (not a true hedge)
- Other strategies (i.e. straddles, etc.)

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Basic Hedge Fund Strategies

Long/Short Equity Strategy

- Simultaneously long and short market exposure through stocks, options, and futures
- Can be "net long" or "net short" the market (net = longs minus shorts)
- Can be US markets, international, or emerging markets

Relative Value Strategy

- Long Kohl's/short Target…long Home Depot/short Lowe's
- Long AAA+ corporate bond/short US Treasury
- Long S&P 500 stocks/short S&P 500 Futures
- Long convertible bond/short underlying stock

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Basic Hedge Fund Strategies (con't)

Event Driven Strategy

- Long company being acquired/short acquirer (Time Warner/AOL)
- Senior secured debt of a company to be liquidated (Montgomery Ward)
- Turnaround Situation (Cendant)
- Corporate spin-offs (General Motors Hughes)

Statistical Arbitrage Strategy (one or more of the following)

- Dollar Neutral
- Beta Neutral
- Sector Neutral
- Market Cap Neutral
- P/E Neutral

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IV. Downside Risk Management

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Hedge Fund Principles

- **Every rolling 10 years since 1900, there has been at least 2 or more down years**
  - Preservation of Capital: Avoid the down years
  - Outperform the S&P 500 and Dow Jones by managing the downside risk. You do not need to beat the broad averages in up years to outperform
  - You must avoid the down years

- **Six down years in the last fifteen, despite the best bull market ever**
  - 1987 *
  - 1990
  - 1994 *
  - 2000
  - 2001
  - 2002

*While these two years were positive at year-end, each suffered a major market correction.

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The Importance of Managing Downside Risk

YEAR	HEDGE FUND	S&P 500
1	15%	15%
2	15%	-15%
3	15%	+56%
Value of $1	**$1.52**	**$1.52**

YEAR	HEDGE FUND	S&P 500
1	10%	15%
2	10%	-15%
3	10%	+36%
Value of $1	**$1.33**	**$1.33**

YEAR	HEDGE FUND	S&P 500
1	10%	15%
2	-5%	-15%
3	10%	+18%
Value of $1	**$1.15**	**$1.15**

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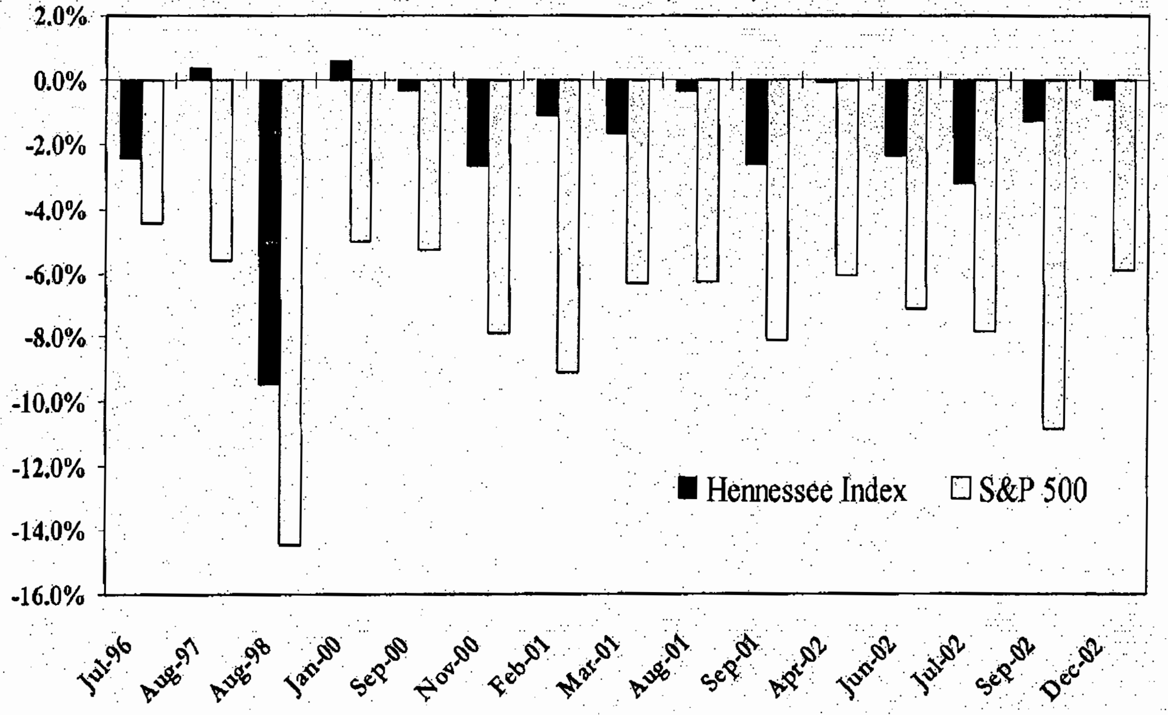
Hennessee Index During the Worst 15 Months of S&P Decline

(Jan 1, 93 to Jan 1, 2004)



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Hennessee Index During the Worst 15 Months of S&P Decline

(Jan 1, 1993 to Jan 1, 2004)

Month	S&P 500	Hennessee Index	Differential
Jul-96	-4.42%	-2.43%	1.99%
Aug-97	-5.60%	0.34%	5.94%
Aug-98	-14.46%	-9.49%	4.97%
Jan-00	-5.02%	0.59%	5.61%
Sep-00	-5.28%	-0.35%	4.93%
Nov-00	-7.88%	-2.68%	5.20%
Feb-01	-9.12%	-1.15%	7.97%
Mar-01	-6.34%	-1.68%	4.66%
Aug-01	-6.26%	-0.40%	5.86%
Sep-01	-8.08%	-2.60%	5.48%
Apr-02	-6.07%	-0.07%	6.00%
Jun-02	-7.12%	-2.37%	4.75%
Jul-02	-7.80%	-3.23%	4.57%
Sep-02	-10.87%	-1.30%	9.57%
Dec-02	-5.90%	-0.58%	5.32%
Differential	-110.22%	-27.40%	82.82%

The above information has been obtained from sources believed to be reliable, but no guarantee is made with respect to its accuracy. Past performance is no guarantee of future returns.

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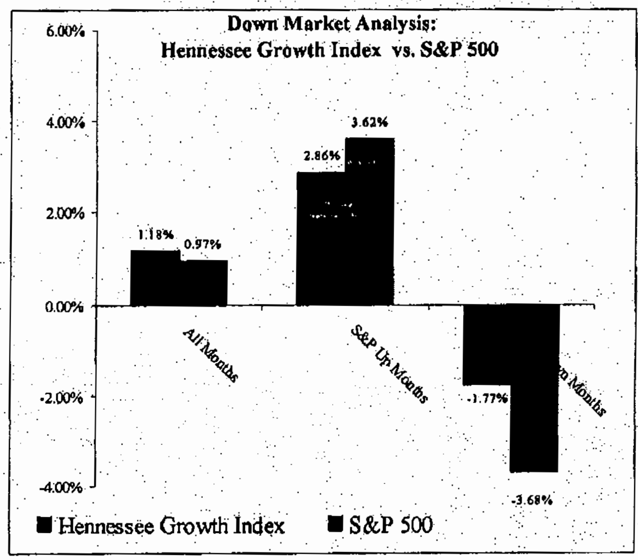
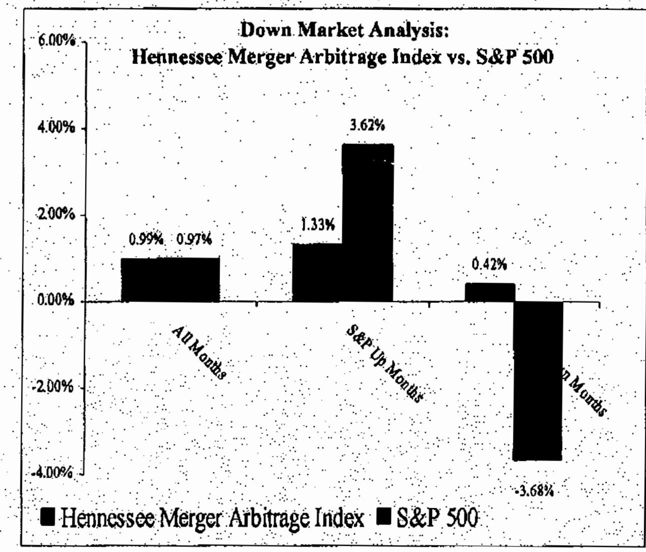
Hedge Fund Theory in Practice

(Jan 1, 1993 to Jan 1, 2004)





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V. Hedge Fund Misconceptions

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Common Hedge Fund Misconceptions

Misconception 1: Mutual Funds have Relative Returns but Hedge Funds have Absolute Returns

- Nothing is absolute about hedge funds
- The belief that any hedge fund can generate an absolute return of 10% to 12% is completely false
- Non-correlated returns is the appropriate term, not absolute returns

Misconception 2: Market Neutral Hedge Funds are Neutral to Market Movements

- True neutrality to market risks (beta, sector, market cap, interest rate, net exposure, etc.) would yield a rate of return equivalent to the one year treasury
- "Market neutral" managers must take some form of market risk to generate returns…in 1999 most market neutral managers had negative performance
- Most "market neutral" managers are mainly dollar neutral and take risk in sectors, market caps, beta, etc.

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Common Hedge Fund Misconceptions

Misconception 3: Short Selling is un-American, and Bad for the Markets

- Short selling provides for a more liquid and efficient market
- Every short sale of a stock is a future buy
- Enron and WorldCom were initially exposed by shortsellers

Misconception 4: Hedge Funds Accelerate Market Corrections and Bear Markets

- NYSE studies of the 1929 crash, the bear market of 1970's, and the 1987 crash, revealed that short selling was not the root cause of these events
- These market downturns were exacerbated by a mismatch of mandatory sellers and optional buyers

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Common Hedge Fund Misconceptions

Misconception 5: Hedge Funds Move Markets

- Hedge funds represent 6% of the daily volume of the U.S. equity and over-the-counter markets
- In fact, the true market movers are "program traders" who account for roughly 38% of the daily volume of the NYSE and investment banks hedging their overnight exposure
- Financial futures managers.............Impact on cash market

Misconception 6: There is a Bubble in Hedge Funds Similar to the NASDAQ Bubble of the 1990s and the Nikkei Bubble of the 1980s

- Bubbles occur when demand exceeds supply for an asset class that drives price levels to unsustainable levels well above its intrinsic value
- Hedge funds are bought and sold at book value (NAV)......never above intrinsic value
- Hedge funds are more like banks- they can accept too much in deposits, resulting in performance decline, not a bubble burst

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Common Hedge Fund Misconceptions

Misconception 7: Hedge Funds are Riskier than Mutual Funds

- Hedge funds outperform traditional money managers not because of excessive risk taking, but because of their ability to reduce risk by hedging, short selling, options, futures, raising cash, etc.
  - Historically, hedge funds have outperformed all major indices with less standard deviation (risk)

Misconception 8: Hedge Funds are *Completely* Unregulated

- Results of the Hennessee Group's 2004 Hedge Fund Manager Survey revealed that 58% of hedge funds are registered with one or more regulatory agencies (i.e. SEC, CFTC, and/or NASD)
- Hedge funds with over $100 million in assets are required to post a quarterly 13F filing with the SEC which discloses all long positions in the portfolio
- Hedge funds are subject to the same trading rules of the SEC, NYSE, and NASD as all other investors (i.e. uptick rule, insider trading, 13D filing...)

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Hedge Fund Disclosure

- **Hedge funds can be speculative and may involve a high degree of risk.**
- **Hedge funds may use leverage.**
- **Hedge funds may have performance that is volatile.**
- **An investor could lose all or a substantial amount of their investment.**
- **The fund manager has total trading authority over the fund. The use of a single advisor applying generally similar trading programs could result in a lack of diversification and, consequentially, higher risk.**
- **There is no secondary market for the investor's interest in the fund and none is expected to develop.**
- **There may be restrictions on redeeming interests in the fund.**
- **The fund's fees and expenses may offset the fund's trading profits.**
- **Some hedge funds can execute a substantial portion of the trades executed for the fund on a foreign exchange.**

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Descriptions of Indices

Hennessee Hedge Fund Index®

The Hennessee Hedge Fund Indices® are calculated from performance data supplied by a diversified group of hedge funds monitored by the Hennessee Hedge Fund Advisory Group®. The Hennessee Hedge Fund Index® is believed to represent over half of the capital in the industry and is an equally-weighted average of the funds in the Hennessee Hedge Fund Indices®. The funds in the Hennessee Hedge Fund Index® are believed to be statistically representative of the larger Hennessee Universe of over 3,000 hedge funds and are net of fees and unaudited. Past performance is no guarantee of future returns.

Hennessee Correlated Index®

Long/short equity funds that invest in US domestic stocks that the portfolio manager believes will appreciate in value and short stocks that the portfolio manager believes will depreciate in value. Volatility and return expectations are generally higher than non-correlated funds because of the manager's utilization of market risk, and hence the fund's long-term correlation to the US equity markets.

Hennessee Non-Correlated Index®

Funds that invest in arbitrage opportunities or event driven situations. Volatility and return expectations are generally lower than correlated funds because of the manager's desire to minimize market risk and focus on individual opportunities within the equity and fixed income markets.

Hennessee Global Index®

Funds that invest in securities (equity, fixed income, currencies, or commodities) with an international scope. Strategies range from long/short equity managers to macro hedge funds. Volatility and return expectations are generally equivalent to correlated funds because of the manager's utilization of market risk.

Standard & Poor's 500 Index (S&P 500) DRI

The S&P 500 Index is an unmanaged market capitalization-weighted measurement of changes in stock market conditions based on the average weighted performance of 500 widely held common stocks. The Index does not reflect sales charges, commissions, expenses or taxes. It is calculated on a monthly basis with monthly dividends reinvested at month end.

Russell 2000 Index

The Russell 2000 Index is an unmanaged market capitalization-weighted index of 2,000 small company stocks. The Index does not reflect sales charges, commissions, expenses or taxes.

Lehman Brothers Intermediate Government Corporate Bond Index

The Lehman Brothers Intermediate Government Corporate Bond Index is an unmanaged market value-weighted index of government and investment-grade corporate fixed-rate debt issues with maturities between 1 and 10 years. The Index does not reflect sales charges, commissions, expenses or taxes.

Dow Jones Industrial Average

The Dow Jones Industrial Average is an unmanaged price-weighted index based on the stock prices of 30 major industrial companies. The Dow Jones Industrial Average does not reflect sales charges, commissions, expenses or taxes.

MSCI EAFE (USD) Price Index

The MSCI EAFE Index is an unmanaged arithmetic, capitalization-weighted average of the performance of approximately 1,000 securities listed on the stock exchange of the countries determined by MSCI to be "developed". The Index does not reflect sales charges, commissions, expenses or taxes.

NASDAQ Composite Index

The NASDAQ Composite Index is an unmanaged index of over 5,000 over-the-counter stock prices that does not assume the reinvestment of dividends. The Index does not reflect sales charges, commissions, expenses or taxes.

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EXHIBIT A(7)

Unknown

From: Brian.Snider@HHFD.COM
Sent: Thursday, May 13, 2004 3:23 PM
To: cmcguire@DEPAUW.EDU
Subject: Re: new contact info

Forbes- Sleaziest Show on Eart... pic02033.pcx (2 KB) pic24490.pcx (2 KB)

Here is the Forbes article again. Your committee members might ask about it, so I want you to be prepared. (See attached file: Forbes-Sleaziest Show on Earth 5-24-04.doc)

---------------------- Forwarded by Brian Snider/CLR/WPGINVEST on 05/13/2004 04:20 PM ---------------------------

Brian Snider
05/12/2004 01:06 PM

To: "Carla McGuire" <cmcguire@depauw.edu>
cc:

Subject: Re: new contact info (Document link: Brian Snider)
(Embedded image moved to file: pic02033.pcx)

Thanks Carla. I just wanted to make sure you received my email on LibertyView and the Forbes article that I forwarded to you. I hope all is well. Regards, Brian

"Carla McGuire" <cmcguire@depauw.edu> on 05/12/2004 12:35:35 PM

To: "Brian Snider" <Brian.Snider@HHFD.COM>
cc:

Subject: new contact info
(Embedded image moved to file: pic24490.pcx)

Brian,

Below is my AZ info. Sorry that I didn't send it sooner. The phones in Chicago are supposed to forward. I know the voice line is, but I am still have trouble with the fax number. It is not forwarding. If you would simply update your records with the AZ information. The condo is under contract to close on June 29th and the St. Louis location will not be online until August.

Thanks

Carla

Carla C. McGuire, CFA
Chief Investment Officer
DePauw University
126 Forest Highlands
Flagstaff, AZ 86001
Phone 928-525-9342
Fax 928-525-9365

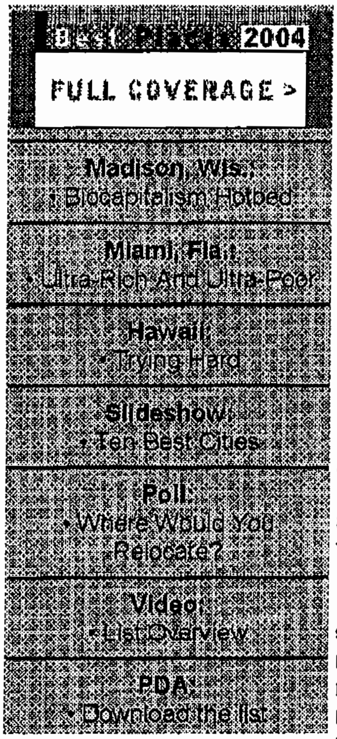
Forbes.com

On The Cover/Top Stories

The Sleaziest Show On Earth

Neil Weinberg Bernard Condon, 05.24.04

Hedge funds will suck in $100 billion this year from an ever-broader swath of investors. Pretty good for a business rife with exorbitant fees, phony numbers and outright thievery.



Koji Goto's pitch for Epic Investment Partners seemed to offer everything a hedge fund investor could want. Epic had a record of earning 80% annually. Goto, though only in his early 30s, was a seasoned veteran who had managed $250 million in client assets. Now he was committing up to $7 million of his own money to Epic. He also claimed to hold exclusive rights to sell frankfurters in Home Depot stores.

All told, Goto told investors to count on earning 500% in a few years. The spiel has been good enough to suck in $6 million from 17 people since 2002. But rather than invest the money in the Epic hedge fund, Goto allegedly funneled $1.4 million to his wife's personal brokerage account and paid lesser sums to Las Vegas' Bellagio Casino, Maserati of New England and Chen Yang Li Restaurant Holdings, in which Goto is an investor. Even the hot dog claim was a whopper. The Securities & Exchange Commission slapped Goto with a securities fraud suit in November, and a New Hampshire grand jury handed up a 68-count indictment in February alleging theft, criminal solicitation and securities fraud. Goto denies the charges.

It's amateur hour in the hedge fund business. This sideshow of sometimes bizarre (and always costly) investing is on a tear like never before. It's attracting some of the shrewdest and sharpest minds on Wall Street--and also shills, shysters, charlatans and neophytes too crooked or too stupid to make any money for you. In 1990 only 600 or so U.S. hedge funds were in business. When we last surveyed the genre (FORBES, *Aug. 6, 2001*) there was $500 billion on the table. Now $800 billion is invested, says Hedge Fund Research, a hedge fund tracker, divided among 6,300 funds--900 of them less than a year old. Besides growth, there is a lot of coming and going in this business. More than 10% of hedge funds tracked by HedgeFund.net became defunct in the past year.

This year eager investors are expected to pump in $100 billion more. The scary part: Hedge funds were once targeted at high rollers who could put up $1 million without a wince, but now they are reaching out to the rest of us. Wall Street is whipping up this craze, with institutions of every stripe hawking hedge funds, from Wachovia to Citigroup's Salomon Smith Barney to Scudder Investments.

The unwashed masses can get into this volatile sideshow for as little as $5,000 *(see "T Bonds and Hog Bellies")*. Among the nation's largest 1,800 pension funds, endowments and

foundations, almost one-quarter held hedge fund investments last year, up from 12% in 2000. Your retirement plan may be next. U.S. pension funds plan to plow $250 billion into hedge funds in future years, 20 times the amount of exposure they have now, says researcher Greenwich Associates. Calpers, the $165 billion retirement fund for California state employees, has invested $500 million and plans to double the sum.

What is driving this red-hot industry: fees that would be outlandish or even illegal if extracted from a plain old mutual fund. "It's obscene," says Alice Handy, who invested in hedge funds for over a decade while running the University of Virginia endowment. "The fee structure is so compelling that everyone and his brother want to run a hedge fund now."

For customers the illusion is that the high fees go hand in hand with high returns. Do they? Hedge funds exist in a lawless and risky realm, exempt from the rules governing mutual funds, equities and most other investments. Hedge funds aren't even required to keep audited books--and many don't. These risky funds often are guilty of inadequate disclosure of costs, overvaluation of holdings to goose reported performance and manager pay, and cozy ties between funds and brokers that often shortchange investors. As for tales of pots of gold at the end of some rainbows, you have to be skeptical. Yes, some funds have racked up stunning results. Others have gone bust. The winners you hear about. The others just disappear from the performance databases. No surprise there: Reporting of performance is voluntary.

Should the government's response to all this be so laissez-faire? The SEC is having some doubts. Chairman William Donaldson, a former chief executive at both the New York Stock Exchange and investment bank Donaldson, Lufkin & Jenrette, vowed to crack down on hedge funds and their wild ways after he took office in February 2003, telling the public: "I don't want this agency to wake up or this country to wake up two years from now and have some huge disaster." But so far the crackdown, such as it is, has been mainly on the thieves, the operators who run off with your money. Vendors who are merely incompetent or greedy have free rein.

If you believe what Wall Street says, hedge funds thrive because they make eminent investment sense for the rich and savvy. "Hedge funds are right for a person with lots of assets who can deal with the downsides," says David Darst, chief investment strategist for Morgan Stanley's individual investor group. George Herbert Walker, a second cousin of the President and head of Goldman Sachs' alternative investment strategies group, adds: "Sophisticated institutional investors have torn apart the hedge fund business. They've read or written the studies and know exactly what they're investing in."

But hedge funds are a hotbed of questionable behavior, whether at blue-chip Wall Street firms or at fly-by-nights. Two youngsters and a 53-year-old assistant literature professor at a small college in New York formed a hedge fund, JB Stanley, and lost most of the $400,000 they raised from 15 investors. They siphoned off the rest for car payments, ATM cash withdrawals and other personal uses, according to SEC claims that led to a summary judgment against the three managers.

At the other end of Wall Street Bear Stearns is under investigation as to whether it helped hedge funds trade illegally; it has fired nine employees amid the probe. Franklin Templeton, CIBC and Merrill Lynch have come under scrutiny over similar allegations in recent months. At Prudential Securities senior executives "knew of and encouraged the dishonest and unethical practices" done on behalf of hedge funds, according to charges filed in December by Massachusetts Secretary of the Commonwealth William Galvin. Prudential says it is cooperating with regulators.

When they aren't getting investigated, even the most sophisticated titans on Wall Street can get taken by hedge funds. Morgan Stanley got fragged in two of the largest blowups in recent years, losing a total of $25 million for investors. The losers: Lancer Management and Beacon Hill's inaptly named Safe Harbor Fund.

Hedge fund managers are drawn to hedge funds by a 20% cut of any profits (the carry) on top of

annual management fees of 1% to 2% of assets plus another 0.4% to 0.6% in administrative fees, says Hennessee Group, a hedge fund consultant. Mutual funds, by contrast, charge fees of 0.2% to 2% of assets.

Investors willingly pay. Why? The hedge fund offers an irresistible velvet rope, the allure of investing where most everyone else hasn't been invited to invest. This mystique is intensified by the arrival of big-name Wall Streeters at hedge funds: Morgan Stanley's longtime chief strategist, Barton Biggs, and its stock strategist, Steven Galbraith; Salomon Smith Barney's chief of government bond trading; and the respected international investment officer of Harvard University. Some cool buzz phrases like "absolute returns" add a little intrigue.

What's wrong with paying a fifth of your profits to some genius who might make you a ton of money? Here's what's wrong: The fee is a lopsided deal. Managers take a fifth of your wins but chip in nothing for your losses. If hedge fund managers, like mutual fund managers, collectively track the market--and there is circumstantial evidence that this is all they can accomplish--the 20% fee is a ticket to gradual impoverishment. Let's say that half of your money is with Hedge Fund X, which shoots up 40%. Half is with Hedge Fund Y, which loses 40%. You are breaking even before incentive fees, but after incentive fees you will be 4% poorer. Annual management and administrative fees will take an additional piece of your hide.

No matter. Oppenheimer Tremont Opportunity Fund, one of the "funds of funds" that have become a favored vehicle at big Wall Street houses, nails investors for as much as a 2.5% load plus 3.2% in annual expenses. That means it must earn about 6% before investors break even. After that, as much as 25% of any profits goes to (winning) managers. Uncle Sam may clip off another 35%, since investors get stuck paying short-term capital gains rates on most hedge fund profits, says Maury Cartine, senior principal for Rothstein Kass, a hedge fund auditor.

The big Wall Street brokerage houses hunger for hedge funds, relishing the high income generated by their furious trading.Though hedge fund holdings equate to 3.6% of all U.S. equities and corporate bonds, they trade so frenetically that they generate 12% of all brokerage commission dollars, for a total of $3.4 billion last year, research firm Sanford C. Bernstein estimates. That's up by 25% in four years. The business of acting as the main, or prime, broker to hedge funds is so lucrative that roughly three dozen firms have jumped into the game. They collect hefty interest income from hedge funds borrowing money to leverage their bets and securities to go short. At Bear Stearns prime brokerage has contributed $1.2 billion in net income in four years, one-quarter of the total, says Bernstein. Bear Stearns dominates the business alongside Goldman Sachs and Morgan Stanley.

One hedge fund manager says the prime brokers' quid pro quo is blunt: Trade through us and trade a lot, and we'll throw clients your way, by putting your fund on our "preferred" sales lists. Brokerage firms also include the favored hedge funds in their funds-of-funds, the SEC says. Morgan Stanley, Goldman Sachs and Bear Stearns say their prime brokerage clients receive no special sales favors.

Many prime brokers also host lavish "capital introduction" parties to pair hedge funds with rich clients. UBS threw a party in St. Moritz last year. Merrill Lynch held one in March at the posh Breakers hotel in Palm Beach, Fla. While the prime brokers pick up the tab for these extravaganzas, hedge fund investors ultimately pay via trading commissions.

Big institutions, including Merrill Lynch, Bank of New York and American Express, often own the hedge funds they sell. Others, like Bear Stearns and Bank of America, run "hedge fund hotels," where they provide office space, brokerage and capital to nominally independent funds.

The association with respectable Wall Street houses scarcely guarantees customers good results. Dozens of investors sued Bank of America in February for allegedly allowing hedge fund Lancer Management to print out phony returns bearing the bank's name, which ultimately

resulted in $571 million in losses. In March, separately, Bank of America agreed to pay $375 million and close its clearing business to settle regulators' claims that it aided Canary Capital Partners, a hedge fund manager, in illegal mutual fund trading

Where investors rank in the hedge fund world is obvious: at the very bottom. The key to keeping their money pouring in is to convince them that hedge funds are a great deal. To do it the industry offers statistics.

Some stuff is entirely made up. Scott Fine and Kevin Boyle, former stockbrokers at Track Securities in Boca Raton, Fla., sent out monthly e-mails boasting of 200% returns in three years at their Condor II fund. Word of mouth lured $10 million into two funds from over 100 investors, some as far away as Saudi Arabia. By the time the SEC sued them in February, Fine and Boyle were down to $2.2 million. "The monthly statements were completely fictitious, but word spread anyway," says Teresa Verges, assistant regional director of the SEC office in Miami. "People said, 'Look at these returns!' and others joined in." Fine says he did not "knowingly violate securities law." Boyle declines to comment.

Paramount Financial Partners claimed to generate annual returns of up to 99% via "technical strategies" and "fundamental analysis." In truth, one of its few investments was U.S. African Corp., a diamond-mining outfit--based in Ohio. Paramount was able to suck in $15 million from the likes of the National Association of Christian Athletes; it used much of the money for personal expenses and marketers, says an SEC securities fraud suit. When the spigot ran dry in 2001, the Ponzi scheme collapsed. Paramount's attorney declined comment.

Some 35% of hedge funds show no dates for their last audits, and their numbers are unreliable, says a 2003 study by Bing Liang of the University of Massachusetts. Arthur Levinson, a wealthy investor in Ft. Lauderdale, Fla., sank $50,000 into Double T Investment Group's hedge fund only to discover much later it had dispensed with audits altogether. By then Double T owner Jon Morrison had lost all the money on bad tech bets. Levinson brought fraud claims to the Florida comptroller's office, where the case languished. "It's an injustice, but I've done everything I can," says Levinson. Morrison, having since declared bankruptcy and now with Summit Brokerage Services, says there are no current claims against him or his defunct hedge fund.

In other cases even audits don't help. Long before Lancer blew up, manager Michael Lauer was "marking the close," or buying thinly traded stocks at the end of each month to goose their values and that of his portfolio, an SEC complaint says. Lauer allegedly inflated the stock of a company with no revenue so much that it made up as much as 23% of his holdings, SEC documents show.

Still, auditor PricewaterhouseCoopers noticed nothing amiss as Lauer lapped up $44 million in fees and incentive pay over three years, an investor suit claims. Bank of America, his prime broker, allegedly let Lauer type in the values of securities it should have calculated independently. Bank of America denies the charges. PricewaterhouseCoopers declined to comment. Lauer says the SEC suit is mostly to blame for Lancer's collapse.

Beyond the numbers are more lies. Kroll Associates, which has been flooded with requests from prospective investors to investigate hedge fund managers in the past few years, says red flags pop up in 15% to 20% of cases, mostly involving college degrees never earned and job titles never held. Christopher Manthey, who runs BackTrack Reports, a New York outfit doing similar work, figures 20% of the 500 managers he looked at in the past year omitted or fabricated something on their résumés.

Paul House played up his experience working for broker-dealers when he managed to persuade 77 investors to put at least $3.1 million into his fund, House Edge. He left out the part about being fired from one firm and barred from associating with NASD member firms for hedge-fund-related misconduct. Also unmentioned: the recent personal bankruptcies of both House and partner Brandon Moore, the SEC says. The pair lost one-half of the money by the time the SEC sued the

fund in 2002. (Hedge funds, though they don't have to follow disclosure laws that govern mutual funds, are subject to SEC and criminal fraud laws.) In a separate criminal prosecution for mail fraud, House recently was sentenced to eight years in the big house.

But even when hedge funds are legit, the way their returns are rated is rife with abuse. The charade begins when managers start up several funds but report results only for the winners, leaving out the losers entirely. This convenient maneuver was present at over half the 3,600 funds tracked by TASS, the industry's largest tracking service and a unit of Oppenheimer Acquisition, according to "A Reality Check on Hedge Funds Returns," a working paper published by Free University in Amsterdam.

It is as if Morningstar allowed mutual fund firms to calculate performance by cherry-picking the winners. Take away this fakery and TASS net returns drop from 10.7% to 6.4% annually for the six years through 2002, the Reality Check study says. (Other academics have come to similar conclusions.) That compares with a 6.9% annual return for the S&P 500 and 7.5% for Lehman Brothers' intermediate bond index.

It gets worse. At the tail end of their lives, hedge funds that suffer lousy returns often stop reporting them long before closing. TASS dismisses much of Free University's "quasi-academic research" and questions the methodology, but declines further comment.

Another way to blow smoke in the customers' eyes is to dress up a performance number in fancy statistical clothing. Popular here: the so-called Sharpe ratio, which adjusts returns for monthly volatility, giving credit to stable performers. This is a handy number to whip out for a manager with mediocre results and a low level of volatility. There is a lot of flexibility in how you arrive at a Sharpe ratio.

Integral Investment Management boasted a high Sharpe ratio before it blew up in 2001, costing the Art Institute of Chicago a reported $39 million. After the institute sued Integral for investing in inappropriately risky securities, a lawyer for now 36-year-old manager Conrad Seghers countered that his client "could have bet on the Super Bowl" and been within his mandate. Seghers says he did nothing illegal and market forces drove his fund out of business. The lawsuit is still pending.

The SEC's harder eye on hedge funds may do little to fix this mess. The commission seems divided over how aggressively to move. Some experts say hedge funds are big enough to destabilize markets and must be understood by regulators. Others, including Federal Reserve Chairman Alan Greenspan, say hedge funds provide a critical source of liquidity for the markets, and advise against too much intrusion on the business. Supposedly, the swells who invest can take care of themselves. That might be a fair argument, if the operators scrupulously steered away from middle-class savers.

Most investors should steer clear of hedge funds. Lush pay has lured the best and brightest to hedge funds, says Michael Price, a hugely successful money manager. But "unless you've got at least $5 million to invest, hedge funds are not worth the risk and fees. Mutual funds will get you where you want to go, so screw hedge funds." With more polite language, Warren Buffett said the same thing at the Berkshire Hathaway meeting recently. A word from the wise.